Economic Recovery— A Workout Plan for the State's Budget

California's Fiscal Challenge

Prior to taking office, the first phase of Governor Schwarzenegger's independent audit of state government finances was released, detailing the size and scope of the fiscal crisis that the Governor and the Legislature must now confront.

Among the key findings of the first phase of the audit were as follows:

- While revenues have increased by 25 percent over the past five years, State expenditures have risen by 43 percent. If government had simply spent at the same rate that California's economy has grown, the State's budget would be balanced today.

- If state government had not spent the extraordinary tax revenues from the one-time surge in capital gains and stock options on ongoing programs, the State budget would not be in the crisis it is in today.

- If, over the past five years, the previous Administration and the Legislature had not created or expanded programs that the State could not afford—expenditures in the Budget would be lower than they are today. In health and human services alone, significant program expansions have totaled $1.3 billion.

- Over the past five years, State bureaucracy has grown and agencies have been allowed to consistently spend above and beyond their budgeted levels.

As a result, by the time Governor Schwarzenegger took office, the State of California had accumulated an inherited debt of more than $22 billion, representing policy and budgetary decisions made by the Legislature and the prior Administration. In the absence of corrective actions to change these policies, the State will continue incurring operating deficits, estimated at $14 billion in fiscal year 2004-05.

In addition, all three major credit rating agencies have lowered the State's credit rating this year. California's General Obligation Bond rating is "Triple B," which is barely above investment grade and is currently the lowest among all the states. Anything below "Triple B" is commonly known as a junk bond.

Total Inherited Debt

Accumulated Deficit Through 2002-03[1/]	$ 9.3 billion
Operating Deficit in 2003-04[1/]	3.0 billion
Total Accumulated Deficit[1/]	$12.3 billion
Effect of Prior Decisions After 2003-04	9.8 billion
Total Inherited Debt	$22.1 billion

1/ In November, the audit projected accumulated deficit through 2002-03 at $10.6 billion, operating deficit in 2003-04 at $4.3 billion, and total accumulated deficit at $14.9 billion. Since then, natural revenue growth and expenditure decreases have exceeded expectations.

California also faces a potential cash crisis this year. In order for the State to meet its daily cash-flow needs, the previous Administration borrowed a total of $14 billion using short-term notes. Those notes are due to be repaid in June 2004.

California Recovery Plan

Faced with such massive and growing debt, the Governor is proposing a four-part economic recovery plan, which consists of the following:

- The Economic Recovery Bond Act to refinance a portion of the inherited debt.
- A budget for 2004-05 that moves toward structural balance.
- A Constitutional amendment to require balanced budgets with prudent reserves in the future.
- Improving the business and jobs climate in order to revitalize the State's economy and improve revenue growth over time.

Economic Recovery Bond Act

The California Economic Recovery Bond Act (Chapter 2, Statutes of 2003, Fifth Extraordinary Session [AB 9]) authorizes, subject to California voter approval at the March 2, 2004, statewide primary election, the issuance of up to $15 billion in bonds to finance the negative General Fund reserve balance as of June 30, 2004, and other General Fund obligations undertaken prior to June 30, 2004. This measure provides that the bonds authorized under the Act may be used to retire any Fiscal Recovery Bonds issued under the provisions of Chapter 13, Statutes of 2003, First Extraordinary Session (AB 7). Under the Act, the State will not be permitted to use more than $15 billion of net proceeds of any bonds issued to address the inherited debt. The bond authorization will replace the currently authorized Fiscal Recovery Bonds. This Act will only become operative if the voters approve this Act and the Balanced Budget Amendment, Chapter 1, Statutes of 2003, Fifth Extraordinary Session (ACA 5) at the March 2004 election.

The repayment of the bond will be secured by a pledge of revenues from an increase in the State's share of the sales and use tax of one-quarter cent starting July 1, 2004, which will be deposited into the Fiscal Recovery Fund. Local governments' share of the sales and use tax will be decreased by a commensurate amount. Beginning in 2004-05, local governments' share of local property tax revenues will be increased by an amount equal to the one-quarter cent reduction in the local sales and use tax. The new sales and use tax rates will automatically revert to current levels as soon as the bond is repaid. The repayment of the bond may be accelerated with transfers from the Budget Stabilization Fund, as specified in the Balanced Budget Amendment. In the event the dedicated revenue falls short, the State also would pledge its full faith and credit by using General Fund revenues to repay the debt service.

The Administration expects the voters to approve the bond at the March 2004 election. However, to be fiscally prudent, the Administration continues to pursue judicial validation and to take all necessary administrative steps to prepare for the sale of the Fiscal Recovery Bonds, as authorized by current law. A final decision on the Fiscal Recovery Bonds will be made after the March 2004 election.

Use of Bond Proceeds—The Administration intends to use the bond proceeds to refinance a portion of the $22 billion inherited debt. It plans to sell bonds sufficient to provide for net proceeds of $12.3 billion for the following:

- $9.242 billion to pay for the accumulated budget deficit through 2002-03.
- $1.881 billion to pay for the State's costs of employee retirement contributions in 2003-04. The 2003 Budget Act assumed these costs would be paid from the proceeds of pension obligation bonds; however, the bond sale has been delayed by court order.
- $188 million in loan repayments to various special funds in 2003-04 and 2004-05.
- $325 million revenue loss in 2004-05 from the prior year due to changes in the use of Net Operating Losses pursuant to the 2002 Budget Act.
- $100 million in increased general obligation debt service in 2004-05 due to the State Treasurer's bond restructuring plan.

- $209 million in increased employee compensation in 2004-05 related to 16 bargaining units delaying a 5 percent bargained pay raise in 2003-04.

- Approximately $300 million contribution to the $635 million General Fund reserve in 2004-05.

Depending on the economic environment, the Administration may elect to sell the remaining amount of bonds in 2005-06 to refinance part of the deferred obligations that will become due in 2005-06 (total due in 2005-06 will be $2.3 billion).

Deficit Recovery Fund—In 2003-04, a new fund will be created for the purpose of deficit recovery. The amount of bond proceeds received but not needed to address the accumulated budget deficit through 2002-03 will be transferred into this fund. The moneys in this new fund will be used in 2004-05 to pay for deferred obligations due in 2003-04 and 2004-05 as outlined above. While the Administration expects the bonds will be sold within the current year, this portion of the bond proceeds must be set aside to allow for a gradual transition to a balanced budget by using the new fund to cover what would otherwise be the General Fund's costs of the inherited debt.

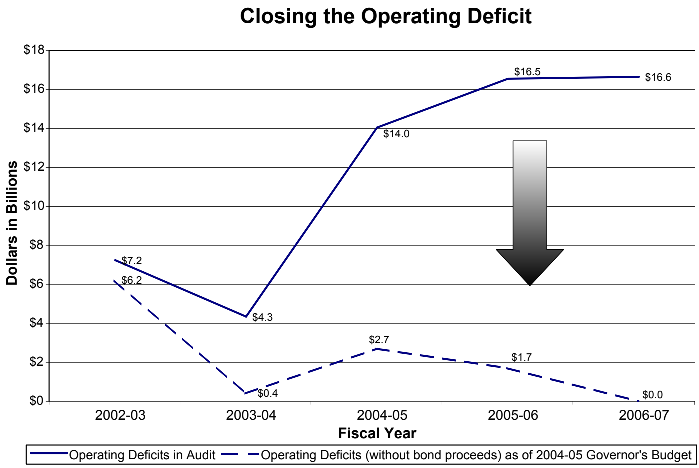
A Budget That Moves Toward Structural Balance

In the absence of policy changes, the State would face a deficit of over $26 billion, consisting of a $9.2 billion year-end deficit in 2002-03, an additional shortfall of $3 billion in 2003-04, and a shortfall of $14 billion in 2004-05.

In December 2003, the Administration proposed reductions totaling $3.9 billion ($2.3 billion in 2003-04 and $1.6 billion in 2004-05). To close the remaining budget gap, additional budget solutions are included in the proposed budget: $0.3 billion in 2003-04 and $12.8 billion in 2004-05 offset by a reduction of $0.8 billion in 2002-03. Overall solutions proposed exceed the projected budget gap by $635 million (the amount of the reserve).

It should be noted that the solutions include the use of a portion of the bond proceeds to create a Deficit Recovery Fund. This allows the State to move in a graduated fashion toward structural budget balance. A combination of factors will close the remainder of the structural gap in 2005-06 and 2006-07. First, an estimated $1.7 billion will remain from the bond to help smooth the transition after 2004-05. Second, many of the reforms contained in the Budget will produce savings that increase dramatically in subsequent years. The Governor is taking a long-term reform approach to government spending, rather than reacting to short-term budget exigencies. And third, it is of supreme importance that the Administration and Legislature enact reforms to improve the business and jobs climate, which in turn should accelerate growth in the State's economy and General Fund revenues.

As the following chart shows, the Governor's measured, long-term approach puts the State on the path to close the operating deficits identified in the audit.



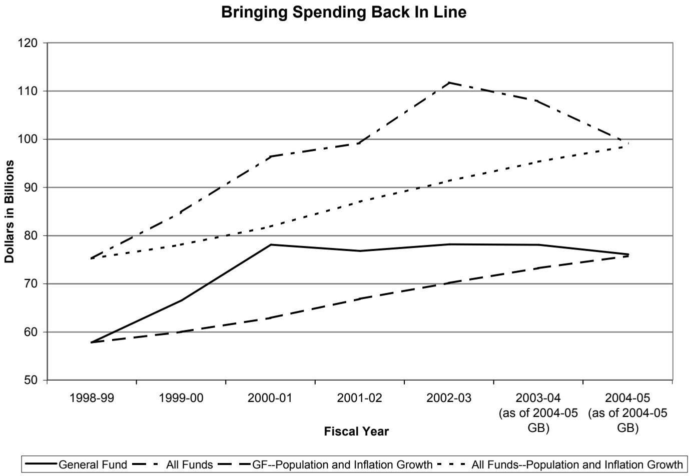
Balanced Budget Requirement, Special Reserve Fund

As part of the Governor's commitment to bring California back to a sound economic foundation, this constitutional amendment (Chapter 1, Statutes of 2003, Fifth Extraordinary Session, ACA 5) will be submitted to the voters on the March 2, 2004, ballot. The proposed amendment will ensure that the State enacts budgets that keep expenditures within available resources. It would also require the State to contribute to a special reserve of 1 percent of revenues in 2006-07, 2 percent in 2007-08, and 3 percent in subsequent years. This special reserve will be used to repay the Economic Recovery Bonds and provide a rainy day fund for future economic downturns or natural disasters. It would allow the Governor to declare a fiscal emergency whenever he or she determines that General Fund revenues will decline below budgeted expenditures, or expenditures will increase substantially above available resources. Finally, it would require the Legislature to take action on legislation proposed by the Governor to address fiscal emergencies.

California's Competitiveness

While California's economic indicators suggest that modest reform is projected for 2004, job growth throughout the state will be tempered due to the high cost of doing business in California. Some estimates conclude that business costs are 30 percent higher in California than in other western states—most note the highest workers' compensation rates in the nation as one of the largest components of the high cost. The workers' compensation system has ballooned from $11 billion to $28 billion in just five years—resulting in 200 percent to 300 percent premium increases for many of the state's employers.

Governor Schwarzenegger's plan for California's Recovery is based on improving the state's business climate to bring jobs back to California. In order to improve the job-generating environment, his plan includes a comprehensive overhaul of the workers' compensation system. In addition, the Governor is harnessing the existing economic development and promotion entities in state government and plans to market California as a desirable place to establish and grow businesses. California's fiscal health is inextricably linked to the state's economic prosperity. Governor Schwarzenegger is committed to increasing economic vitality and promoting the creation of well paying jobs.



- As the statewide chart here shows, the 2004-05 Governor's Budget will bring General Fund spending back in line with the population growth and inflation.